Release Number: **201407017** Release Date: 2/14/2014

INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

Area D	irector,	Area 4	TEGE	Appeals,
Philade	elphia. I	PΑ		

November 22, 2013

UIL Code: 501.03-30

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's ID No.:

Year(s) Involved:

Conference Held:

LEGEND:

Taxpayer =

B =

S =

ISSUE:

Whether the Commissioner, TE/GE, should exercise discretion to grant Taxpayer relief under § 7805(b) of the Internal Revenue Code to limit the retroactive effect of the revocation of its exempt status under § 501(c)(3).

FACTS:

Application for Exemption

Taxpayer applied for tax-exempt status, describing its activities on the Form 1023. Taxpayer stated that it was formed to educate the general public on the use of budgets, spending plans, and the use of credit in developing personal financial plans to meet its current and future needs. It also stated it would use trained, professional counselors to conduct its activities. Counselors would help clients complete a comprehensive analysis to establish a budget. For more serious financial problems when a client is unable to meet his financial obligations, a counselor would set up a debt management plan (DMP). Taxpayer would manage the DMPs, arrange reduced payments with

creditors, and act as a trustee. Taxpayer stated that, as funding and financial support increased, it would increase its educational activities in the following ways:

- Provide group advisory instruction to all age groups when there is a need for credit, budget, and financial counseling services with particular, but not exclusive reference, to those in special and pressing need thereof, through money management workshops conducted by trained professional counselors with extensive training in financial and credit issues. Taxpayer estimated this would begin within six to eight months of operation.
- Form a committee to determine research, education, and public information activities conducive to the general welfare with respect to budgeting, financial matters, and consumer credit.
- Proposed activities would include publishing informational brochures covering numerous financial topics, including, but not excluding, household budgeting, how to re-establish credit, and how to use credit. Brochures would be provided to the public at no cost. Taxpayer would also publish a monthly newsletter designed to educate individuals and families, on an ongoing basis in credit and financial issues. Taxpayer anticipated that its publishing activities would begin within the year of operation.
- Cooperate with public and private agencies, organizations, and associations engaged in similar education counseling programs.

Taxpayer stated it would solicit donations from organizations that provided goods, services, or unsecured loans. It would solicit donations from creditors to offset the cost of administering the DMP. Taxpayer stated that, during its first year of operation, its primary source of support would be the fees it charged to cover the cost of providing services. Taxpayer would require clients to pay for benefits, services, or products provided. However, at the time of application, a fee schedule had not yet been determined, but would closely relate to the services provided.

Taxpayer listed its president, vice president, and secretary when asked to "[g]ive the following information about the organization's governing body: Names, addresses, and titles of officers, directors, trustees, etc." Taxpayer indicated that only one of those individuals would receive annual compensation.

Taxpayer stated that it is not an outgrowth of (or successor to) another organization, or have a special relationship with another organization by reason of interlocking directorates or other factors.

Based upon these representations, the Service issued a favorable determination letter to Taxpayer.

Examination:

The examination concluded that Taxpayer's main activity was enrolling any individual/consumer into DMPs to payoff unsecured debt in a commercial manner. It purchased leads to increase DMP enrollment. Taxpayer's employees and two independent contractors who were compensated on a commission basis conducted the DMP operations. Excluding interest income, the revenue from Taxpayer's DMP services was its primary source of income, which includes fees for a credit report; set-up fees; monthly fee payments, and fair share income from the creditors. Taxpayer's counseling activities were nothing more than sales activities. It provides no actual counseling to consumers. The agent found that Taxpayer's employees did not receive training on how to provide educational counseling to clients on personal money management. The employees were only trained to sell DMPs regardless of whether the consumers' situation warranted it. The agent found that, although Taxpayer maintained a website on credit and money management, it contained very little educational information. Clients were never required to visit the website.

The exam agent also found that, from inception through the final year of exam, Taxpayer's Board of Directors consisted exclusively of three related individuals—all of whom were ********** Taxpayer's former president. Only one of those directors was listed on Taxpayer's Form 1023—Taxpayer's secretary. The exam agent further found that Taxpayer contracted with a corporation, B. Taxpayer's former president owned and operated the company, which provides credit card processing services for Taxpayer's DMPs. Taxpayer contracted with a second corporation, S. Taxpayer's then-current president served as an officer and employee of S, which creates and produces monthly newsletters as well as other materials and brochures. S also provides consultation and creative placement of all radio and television broadcasting and print advertising.

Taxpayer appealed the proposed revocation. Appeals sustained the revocation. Following the appeals process, the National Office received this request for relief from retroactive revocation as a mandatory TAM.

Legal Standard:

Section 7805(b)(8) provides that the Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect.

Section 1.501(a)-1(a)(2) of the Income Tax Regulations states that an organization that the Commissioner determined to be exempt under § 501(a) may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation, and subject to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations, or for other good cause.

Section 301.7805-1(b) of the Procedure and Administration Regulations grants the Commissioner authority to prescribe the extent to which any ruling issued by his authorization shall be applied without retroactive effect.

Section 4.04 of Rev. Proc. 2013-5, 2013-1 I.R.B.170, states that all requests for relief under § 7805(b) must be made through a request for technical advice (TAM). Section 19.04 states further that when, during the course of an examination by EO Examinations or consideration by the Appeals Area Director, a taxpayer is informed of a proposed revocation, a request to limit the retroactive application of the revocation must itself be made in the form of a TAM and should discuss the items listed in § 18.06 of Rev. Proc. 2013-5, as they relate to the taxpayer's situation.

Section 18 of Rev. Proc. 2013-5 lists the criteria necessary for granting § 7805(b) relief as well as the effect of such relief. Section 18.06 states, in part, that a TAM that revokes a determination letter is not applied retroactively if:

- (1) there has been no misstatement or omission of material facts;
- (2) the facts at the time of the transaction are not materially different from the facts on which the determination letter was based:
- (3) there has been no change in the applicable law; and
- (4) the taxpayer directly involved in the determination letter acted in good faith in relying on the determination letter, and the retroactive revocation would be to the taxpayer's detriment.

Rev. Proc. 2013-9, 2013-2 I.R.B. 255, sets forth procedures for issuing determination letters (from EO Determinations) and rulings (on applications for recognition of exempt status by EO Technical) on the exempt status of organizations under § 501. These procedures also apply to revocation or modification of determination letters or rulings.

Section 12.01 of Rev. Proc. 2013-9 states, in part, that the revocation or modification of a determination letter or ruling recognizing exemption may be retroactive if the organization omitted or misstated a material fact, or operated in a manner materially different from that originally represented. In certain cases an organization may seek relief from retroactive revocation or modification of a determination or ruling under § 7805(b) of the Code using the procedures set forth in Rev. Proc. 2013-4, 2013-1 I.R.B. 126, which further refers to Rev. Proc. 2013-5, §§ 18 and 19.

Section 12.01(1) of Rev. Proc. 2013-9 states that where there is a material change inconsistent with exemption in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change.

In <u>Automobile Club of Michigan v. Commissioner</u>, 353 U.S. 180, 184 (1957), the Supreme Court held that the Commissioner has broad discretion to revoke a ruling

retroactively. It further held that a retroactive ruling "may not be disturbed unless...the Commissioner abused the discretion vested in him..." Id.

In <u>Stevens Bros. Foundation, Inc. v. Commissioner</u>, 324 F.2d 633, 641 (1963), the court found the Foundation's efforts "far from convincing" to demonstrate that its information reports were adequate and sufficient to apprise the Commissioner of its entry into the business activities which led to denial of its tax-exempt status. Shortly after receiving its tax-exempt ruling, the Foundation contracted with a for-profit company, but failed to disclose this fact to the Commissioner on its Forms 990. The court upheld the Service's retroactive revocation.

In <u>Variety Club Tent No. 6 Charities, Inc. v. Commissioner</u>, 74 T.C.M. (CCH) 1485 (1997), the court held that petitioner "operated in a manner materially different from that originally represented." The organization represented in its exemption application and articles of incorporation that no part of its net income would inure to the benefit of any private shareholder or individual. But the court found instances of inurement over several years, and upheld the Service's retroactive revocation for such years.

ANALYSIS:

During the years under exam, Taxpayer's operations were materially different from the description it provided in its exemption application. See Variety Club Tent No. 6 Charities, 74 T.C.M. at 1485; Rev. Proc. 2013-9 at § 12.01. Taxpayer claimed on its Form 1023 that it was formed to educate the public on using budgets, spending plans, and using credit in developing personal financial plans. However, the examination revealed that Taxpayer's counseling activities were nothing more than DMP sales activities. Thus, Taxpayer did not provide education specifically tailored to the needs of its clients and the general public. Taxpayer also claimed on its Form 1023 that DMPs would be established for individuals with serious financial problems. However, the examination revealed that its DMP activities were presented as a solution to any individual seeking Taxpayer's services. Taxpayer's main activity was enrolling individuals into DMPs to payoff unsecured debt in a commercial manner. Furthermore, the payments it initially characterized as "donations" from creditors on the Form 1023 were in fact "fair share" payments. The examination also revealed that Taxpayer omitted all of the directors on its governing board from its Form 1023. The exam found that the directors are all ****** of Taxpayer's former president. Moreover, Taxpayer claimed on its Form 1023 that it does not have a special relationship with another organization by reason of interlocking directorates or other factors. However, the examination revealed that Taxpayer was contracting with related corporations for services. Taxpayer's former president owns and operates one of those corporations, and Taxpayer's current president is also an officer and employee of the second corporation.

Therefore, revocation may be retroactive to the first year under examination, when the Service determined Taxpayer made material changes to its operations. See

<u>Automobile Club of Michigan</u>, 353 U.S. at 184 (Commissioner has broad discretion to revoke a ruling retroactively); Rev. Proc. 2013-9 at § 12.01(1) (revocation ordinarily applies as of the date of material changes in operation).

Recommendation:

The Commissioner, TEGE, has declined to exercise discretion to limit the retroactive effect of revocation of exempt status under § 501(c)(3). Revocation is effective as of the first day of the first tax year under exam.